

1/1. Examinable syllabus guide for
DECEMBER 2024 TO JUNE 2025 according to ACCA

Accounting policies, changes in accounting estimates and errors

- Identify items requiring separate disclosure, including their accounting treatment and required disclosures.
- Recognise the circumstances where a change in accounting policy is justified.
- Define prior period errors.
- Account for the correction of errors and changes in accounting estimates and changes in accounting policies.

After studying our material and solving related questions, please refer back to the points above to make sure you fully cover it well.

1/2. Qualitative characteristics of useful accounting information

Qualitative characteristics of useful accounting information	
Fundamental qualitative characteristics	Enhancing qualitative characteristics
1. Relevance; Predictive value, confirmatory value <i>or</i> both and material.	1. Comparability; Consistency aids comparability
2. Faithful representation; Completeness, neutrality and free from error.	2. Verifiability;
	3. Timeliness;
	4. Understandability; Classifying, characterising <i>and</i> presenting information clearly And concisely.
<i>Subject to</i> pervasive constraint cost/benefit	

1/3. Importance of **consistency and comparability** in financial reporting

1. Comparability is one of **enhancing qualitative characteristics** of accounting information.
2. Comparability among F/S^s is an important **objective** of financial reporting.
3. Comparability is enhanced *through* consistency in application of the same accounting policies from year to year in the preparation of F/S^s.
4. IAS # 8 **requires** the presentation of prior year's F/S^s for **comparative** purposes.
5. For information to be **comparable**, like things must look alike and different things must look different.
6. While full **comparability** will **not** be achieved *as long as* alternative principles of accounting and reporting for like transactions *and* events remain available; the IASB strives to reduce alternatives within IFRS Accounting Standards to enhance **comparability** among F/S^s produced by essentially similar entities to facilitate informed economic decision making by F/S^s users.
7. IAS # 8 attempts to reduce the risk of non-comparability by *requiring*:

A. Retrospective application *when* justifiably adopting new accounting policies; *and*

B. Retrospective restatement of prior periods' F/S^s for **corrections of errors**.

To achieve transparency *and* enhance inter-period **comparability** of information in F/S^s which enhances its decision usefulness.

8. There is a general presumption that the benefits derived from **restating** comparative information will **exceed** the resulting cost *and* effort of doing so.

1/4. Scope of IAS # 8

1. The accounting *and* disclosures of **accounting changes** (change in accounting policy and change in accounting estimate);
2. The accounting for the **correction of errors** (errors are not considered an accounting change).

2/1. 'Accounting policies'

1. **Accounting policies** are **specific** principles, bases, conventions, rules and practices adopted by an entity in preparing and presenting the F/S⁵.

2. Per IAS # 1 the entity's management is responsible for selecting and applying **accounting policies that**:

A. **Present fairly** financial position, results of operations and cash flows of the reporting entity;

B. Present financial information in a manner that is **relevant, reliable, comparable and understandable**;

Thus; Management should **select** among acceptable alternative **accounting policies** those **policies** that reflect the **economic reality** of transactions and events presented in the F/S⁵.

3. Because disclosures of chosen **accounting policies** is an essential for a **proper understanding** of the information contained in the F/S⁵; management is required to **disclose** in the notes to the F/S⁵ a description of **all significant accounting policies** of the reporting entity.

Thus; 'Summary of significant accounting policies' is customarily (*but not necessarily*), the **first note disclosure** included in the F/S⁵.

2/2. Consistency of applying accounting policies

1. IAS # 8 states that:

In preparation of the F/S^s there is an underlying **presumption** that an **accounting policy** once adopted should **not** be changed from period to period *but rather* is to be **uniformly applied** in accounting for transactions *and* events of a **similar type** *without exception* **unless** the **changes** can be justified *or* promulgated by new standards.

.....

This **consistency** in **application** of **accounting policies** enhances **comparability** *and* enables users to identify **trends** in the entity's F/S^s for **predictive** purposes.

Thus: Changes in accounting policy are **only** permitted *if*:

A. The **voluntary** change will result in more **relevant** *and* **reliable** presentation of transactions *or* events in the F/S^s of the reporting entity *such as* a Sub's changes its **accounting policies** *when* being newly acquired by a group that uses different accounting policies (the change is **justifiable**) *or*

B. The change is **required** by a new IFRS Accounting Standard *or* an interpretation;

Illustrative example: Milan computerised its accounting system. (FIFO) method were used for inventory valuation under manual system, the computerised system which is ***tailor-made for the industry*** to which Milan belongs is capable of valuing inventories under weighted average (W.A) method **only** and is not equipped to value inventories under FIFO.

Required: Does Milan change of inventory valuation policy is justifiable?

Answer: Yes because industry best practice dictates that **only W.A** is **appropriate**. This is a **voluntary justifiable** change in **accounting policy** from FIFO to W.A because it results in F/S^s providing **reliable** *and* more **relevant** information (inventory *and* cost of sales are **comparable** to other entities within the industry to which the entity belongs).

2. Examples of changes in accounting policies:

A. A change in inventory costing from 'W.A' to 'FIFO' *or* vice versa under IAS # 2 'Inventories';

B. A change from cost model to F.V model of accounting for investment property under IAS # 40 'Investment property';

C. A change from cost model to revaluation model of accounting for PPE *and* intangible assets under IAS # 16 'PPE' *and* IAS # 38 'Intangible assets'

Note that; Provisions of IAS # 8 are **not** applicable to the **initial adoption** of revaluation model for PPE *and* intangible assets *although* such adoption is indeed a change in accounting policy. But **initial** change from cost model to revaluation model is dealt with in accordance with the provisions of IAS #16 / IAS # 38 *as appropriate*.

D. A change from F.V to proportionate share of the value of net assets acquired for valuing non-controlling interest (NCI) in business combinations (IFRS Accounting Standard # 3).

3. A change in accounting policy requires adequate disclosures of the **nature** of the change and its **effects**.

4. Two types of events do **not** constitute a change in accounting policy under IAS # 8:

A. Adopting an accounting policy for a new type of transactions *or* events not dealt with previously by the entity; *and*

B. Adopting a new accounting policy for a transaction *or* event which was not material in prior periods.

2/3. Change in an accounting policy and 'Retrospective application'

1. If **initial** application of an **accounting policy** is made consequent to the enactment of a new IFRS **Accounting Standard**, the change in the **accounting policy** is accounted for in accordance with the **transitional provisions** set out in that standard.

In the absence of any specific transitional provisions in a new standard, a change in an **accounting policy** is to be applied **retrospectively**.

2. Voluntary changes in accounting policy are accounted for by **retrospective application**.

Retrospective application of a new accounting policy means applying the new accounting policy to past transactions, events and conditions as if that policy has always been applied (*unless it is impracticable to do so*).

3. Steps required for **retrospective application**

Illustrative example (1): Previously, Adam expensed its borrowing costs. Before F/S⁵ of 2019 issuance, Adam intended to capitalise these borrowing costs relating to a factory under construction. The change is made to be consistent with industry practice.

Borrowing costs related to this construction that expensed were: \$4,000 before 2018, \$2,500 during 2018 and \$3,000 for 2019.

The Statements of P/L **before retrospective application** for 2018 and 2019 **before** adjusting for policy change are as follows:

Description	2018	2019
Operating profit	\$20,000	\$30,000
Finance cost	(3,800)	(4,800)
Profit before tax	16,200	25,200
Tax expense (20%)	(3,240)	(5,040)
Net profit for the year	12,960	20,160

The 2018 opening R.E^s were \$15,000 and \$18,000 share capital, no other components of equity *other than* R.E^s

Note: Depreciation is not recognised as factory is not in use.

Statement of changes in equity before retrospective application						
Description	2018			2019		
	Share capital	R.E ^s	Total	Share capital	R.E ^s	Total
Beginning equity at 1, Jan, 2018	\$18,000	\$15,000	\$33,000	\$18,000	\$27,960	45,960
Profit for the year	0	12,960	12,960	0	20,160	20,160
Ending equity balances	18,000	27,960	45,960	18,000	48,120	66,120

Required: Prepare the statement of P/L and the statement of changes in equity for the period-ended 31, Dec, 2019 with comparatives.

Answer:

Comparative statements of P/L- retrospective application for 2018		
Description	2018 ' as adjusted '	2019
Operating profit	\$20,000	\$30,000
Finance cost	(1,300)	(1,800)
Profit before tax	18,700	28,200
Tax expense (20%)	(3,740)	(5,640)
Net profit for the year	14,960	22,560

Note: In presenting the previously issued F/S^s (2018), the caption '**as adjusted**' is included in the column heading.

Statement of changes in equity- retrospective application						
Description	2018			2019		
	Share capital	R.E ^s Restated	Total	Share capital	R.E ^s	Total
Beginning equity balances as originally stated at 1, Jan, 2018	\$18,000	\$15,000	\$33,000	\$18,000	\$33,160	\$51,160
Plus : Change in accounting policy from expensing to capitalising borrowing costs net of taxes *	-	3,200	3,200	-	-	-
Beginning balances as restated	18,000	18,200	36,200	0	0	0
Profit for the year	0	14,960	14,960	0	22,560	22,560
Ending equity balances	18,000	33,160	51,160	18,000	55,720	73,720

*Adjusting the beginning R.E^s balance net of tax for the **earliest** prior period presented (1, Jan, 2018).

$$\$4,000 \times 80\% = \$3,200.$$

Cumulative adjusting entry

Dr: Construction in progress (\$4,000 + \$2,500 + \$3,000) = \$9,500

Cr: Income tax payable (\$9,500 × 20%) = \$1,900

Cr: R.E^s (\$9,500 × 80%) = \$7,600

Illustrative example (2): Tefal changed its accounting policy in 2019 with respect to the valuation of inventories.

Up to 2018 inventories were valued using W.A cost method. In 2019 the method was changed to FIFO as it was considered to more accurately reflect the usage *and* flow of inventories in the economic environment.

The impact on change in inventory valuation was determined as follows:

Date	Effect of change from W.A to FIFO on ending inventory
31, Dec, 2017	An increase of \$10,000
31, Dec, 2018	An increase of 15,000
31, Dec, 2019	An increase of 20,000

The statements of P/L before retrospective application		
Description	2018	2019
Sales	\$250,000	\$300,000
Cost of sales	(120,000)	(140,000)
Gross profit	130,000	160,000
Selling and distribution costs	(20,000)	(25,000)
Administration expenses	(40,000)	(50,000)
Net profit	70,000	85,000

Required: Present the **change in accounting policy** in the Statement of P/L and the Statement of changes in Equity in accordance with the requirements of IAS # 8, *assuming* 1, Jan, 2018 R.E balance was \$260,000. Ignore income taxes

Answer: Changes in inventory affects cost of sales as follows:

Effects of change from W.A to FIFO			
Description	2017	2018	2019
Changes in ending inventory	\$10↑	\$15↑	\$20↑
Net effect on cost of sales	10↓	5↓	5↓
Net effect on profits	10↑	5↑	5↑

The statements of CI after retrospective application		
Description	2018 ' as adjusted '	2019
Sales	\$250,000	\$300,000
Cost of sales	(115,000)	(135,000)
Gross profit	135,000	165,000
Selling <i>and</i> distribution costs	(20,000)	(25,000)
Administration expenses	(40,000)	(50,000)
Net profit	75,000	90,000

Note: In presenting the previously issued F/S^s (2018), the caption '**as adjusted**' is included in the column heading.

Statement of changes in R.E ^s retrospective application		
For the year-ended 31, Dec, 2019		
Description	2018 Restated	2019
Beg. R.E ^s at 1, Jan, 2018, as originally stated	\$260,000	\$345,000
Add: Change in accounting policy for valuation of inventory	10,000	-
Beginning balances as restated	270,000	-
Profit for the year (profit for the year-ending 31, Dec, 2018 as restated)	75,000	90,000
Ending R.E ^s balance	345,000	435,000

Note: The cumulative impact at 31, Dec, 2018 is an increase in R.E^s of \$15,000 *and* \$20,000 at 31, Dec, 2019.

Cumulative adjusting entry

Dr: Inventory \$20,000

Cr: R.E^s \$20,000

4. **Changes in accounting policies** sometimes *results in indirect effects* on the entity^{'s} F/S^s amounts from legal *or* contractual obligations *such as* profit sharing *or* royalty arrangements that could contain monetary formula based on amounts in the F/S^s.

IAS # 8 specifies that **indirect effects** are to be recognised in the period in which the entity makes the accounting change.

Illustrative example (3): Assuming a change in an accounting policy from WA inventory valuation to FIFO is adopted in the year-ended 31, Dec, 2019 and assume comparative 2018 F/S⁵ is to be presented along with 2019 F/S⁴.

Required: Discuss the required steps necessary for a retrospective application of the new accounting policy.

Answer:

A. Adjust the carrying amounts of the opening balances for the earliest prior period presented (1, Jan, 2018) of corresponding assets/liabilities and the offsetting effect on R.E⁵ for the cumulative effect of changing to the new accounting policy on periods prior to those comparatively presented in the F/S⁵ (periods prior to 1, Jan, 2018);

B. Adjust the F/S⁵ for the effects of applying the new accounting policy to that comparative specific periods presented (year 2018) by retrospective application of the new accounting policy to the affected items in those F/S⁵ as if the new accounting policy had always been applied. And apply the new accounting policy in the year of change (2019);

C. A third statement (31, Dec, 2017) of SFP must be presented as part of the minimum comparative information.

Retrospective application to prior periods is required as long as it is practicable to determine the effect of the change on the amounts in both the opening as well as closing SFP for prior periods (years before 2018 and 2018)

Illustrative example (4): In 2019 Bella decides to switch from FIFO to the W.A of inventory valuation. The statement of P/L for 2018 under FIFO was as follows:

Description	Subtotal	Total
Revenue		\$900,000
Opening inventory	235,000	
Purchases	346,000	
Closing inventory	(274,000)	
Cost of sales		(307,000)
Gross profit		593,000

Opening inventory for 2018 based on WA would be \$222,000 and closing inventory would be \$243,000

Required: Restate statement of P/L for 2018 based on the W.A.

Answer:

Description	Subtotal	Total
Revenue		\$900,000
Opening inventory	222,000	
Purchases	346,000	
Closing inventory	(243,000)	
Cost of sales		(325,000)
Gross profit		575,000

Notes:

1. Gross profit for 2018 will be reduced by \$18,000.

2. The opening inventory for 1, Jan, 2019 will be \$243,000 rather than \$274,000.

3. The statement of changes in equity for 2018 will show \$13,000 reduction to opening R.E⁵ due to decreasing inventory from \$235,000 under FIFO to \$222,000 under W.A, ignoring income tax effects.

4. In order to prepare comparative figures for 2017 showing the change of accounting policy, it is necessary to recalculate the amounts for beginning inventory at 1, Jan, 2017 under W.A.

Illustrative example (5): Cannon has recently adopted IFRS Accounting Standards and its existing policy of writing off of all development expenditure is no longer considered appropriate under IAS # 38 'Intangible assets'. The new policy to be first applied for the F/S^s for the year-ended 30, Sep, 2020. Cannon will recognise development costs as an intangible asset where they comply with the requirements of IAS # 38. Amortisation of all qualifying development expenditure is on a straight-line basis over a four-year period started from the year it occurs (assuming \$nil residual value).

The Statements of P/L before retrospective application of the new policy for 2019 and 2020 before adjusting for policy change are as follows:

Description	Year-ended 30, Sep	
	2019	2020
Revenue	\$90,000	\$95,000
Cost of sales	(35,000)	(37,000)
Gross profit	55,000	58,000
Operating costs	(10,000)	(11,000)
Operating profit	45,000	47,000
Development expenders	(5,500)	(4,600)
Finance cost	(2,500)	(2,400)
Profit before tax	37,000	40,000
Income tax expense (25%)	9,250	(10,000)
Net profit	27,750	30,000

The following are amounts of development costs actually expensed in P/L and the amounts that should be capitalised and amortised for the years-ending 30, Sep, 2018 to 30, Sep, 2020.

Date	Amount recognised in P/L	Amount qualifying as an asset for amortisation
In the year to 30, Sep, 2018	\$5,000	\$4,200
In the year to 30, Sep, 2019	5,500	4,600
In the year to 30, Sep, 2020	4,600	3,500

No development costs were incurred by Cannon prior to 2018. Changes in accounting policies should be accounted for under IAS # 8 'Accounting policies, changes in accounting estimates and errors'.

Required: Prepare statement of P/L for 2020 and comparative statement of P/L for 2019 on retrospective basis and extracts of Cannon's SFP for the years to 30, Sep, 2020 including the comparative figures to reflect the change in accounting policy assuming R.E^s balance at 30, Sep, 2018 is \$9,000.

Answer:

The statements of P/L after retrospective application		
Description	Year-ended 30, Sep	
	2019 ' as adjusted '	2020
Revenue	\$90,000	\$95,000
Cost of sales	(35,000)	(37,000)
Gross profit	55,000	58,000
Operating costs	(10,000)	(11,000)
Operating profit	45,000	47,000
Development expenders	(900) (1)	(1,100) (2)
Amortisation of intangible assets	(2,200) (3)	(3,075) (4)
Finance cost	(2,500)	(2,400)
Profit before tax	39,400	40,425
Income tax expense (25%)	9,850	(10,106)
Net profit	29,550	30,319

(1) $\$5,500 - \$4,600 = \$900$

(2) $\$4,600 - \$3,500 = \$1,100$

(3) $(\$4,200 + \$4,600) \times \frac{1}{4} = \$2,200$

(4) $[(\$4,200 + \$4,600 + \$3,500) \times \frac{1}{4}] = \$3,075$

Statement of R.E ^s		
Description	2019 Restated	2020
Beginning R.E ^s balance	\$9,000	\$40,913
Prior period adjustment net of tax (5)	2,363	-
R.E ^s at 1, Oct, 2018 as restated	11,363	-
Net profit for the year	29,550	30,319
Ending R.E ^s balance	40,913	71,232

(5) $\{[\$4,200] \text{ incorrectly expensed in 2018} - [\$4,200 \times 25\% \text{ amortisation for 2018}]\} \times (1 - \text{T.R } 25\%) = \$2,363$

Description	2018	2019	2020	Total
Actually expensed development cost	\$5,000	\$5,500	\$4,600	\$15,100
Development cost should expensed	(800)	(900)	(1,100)	(2,800)
Amortisation of intangible assets	(1,050)	(2,200)	(3,075)	(6,325)
Excess expenses	3,150	2,400	425	5,975
Tax (25%)				1,494
Net increase in R.E^s for three years				4,481

Cumulative adjusting entry

Dr: Intangible assets $(\$4,200 + \$4,600 + \$3,500) = \$12,300$

Cr: Income tax payable \$1,494

Cr: R.E^s \$4,481

Cr: Acc. Amortisation \$6,325

SFP			
Non-current assets	2018 Restated	2019 Restated	2020
Intangible assets	\$4,200	\$8,800	\$12,300
Less: Acc. Amortisation	(1,050)	(3,250)	(6,325)
Net carrying value	3,150	5,550	5,975

2/4. Impracticability exception

1. **Retrospective** application is not required if it is **impracticable** to do so.
2. **Impracticable** is very **strictly defined** under IAS # 8 in order to preclude avoidance of **restating** earlier periods.
3. **Impracticable** means the entity can't apply the **retrospective** application of the new **accounting policy** after making every reasonable effort to do so.
4. In circumstances where **retrospective restatement** is deemed **impracticable**; the reporting entity will disclose the reason for not **retrospectively restating** the **comparative** amounts of prior periods.
5. Example of reasons that cause **retrospective restatement impracticable**:
 - A. The effects of the **retrospective** application are not determinable;
 - B. The **retrospective** application requires assumptions about what management's intentions would have been at that time;
 - C. The **retrospective** application requires significant estimates of amounts.
6. If it is **impracticable** to determine the effects of adoption of the new **accounting policy** on any prior period; the **new policy** is applied **prospectively** as of the earliest date that it is practicable to do so. (i.e.) the entity should go back as far as it can and the portion of the **cumulative adjustment** to affected assets, liabilities and R.E^s arising before that date is disregarded.

Illustrative example: Prince is a manufacturing firm. During 2019 the directors decide to **change** the valuation method for raw material from W.A cost method to FIFO method. The effects on the value of the inventories are determined as follows:

Description	Weighted average	FIFO
31, Dec, 2018	\$160,000	\$140,000
31, Dec, 2019	190,000	160,000

Prince was **unable** to obtain figures as at 1, Jan, 2018 for inventory in terms of FIFO *due to impracticability*.

Ignore any income tax effects.

Required: Determine the **retrospective** application.

Answer:

Date	Effect of change from W.A to FIFO on ending inventory
31, Dec, 2018	A decrease of \$20,000
31, Dec, 2019	A decrease of 30,000

Effects of change from W.A to FIFO		
Description	2018	2019
Changes in ending inventory	\$20↓	\$30↓
Net effect on cost of sales	20↑*	10↑
Net effect on profits	20↓	10↓

* The Effect of beginning inventory at 2018 on cost of sales **can't** be determined; the decrease of ending inventory by \$20,000 at 2018 would increase cost of sales by the same amount. *Accordingly* **comparative** statement of P/L for 2018 **can't** be presented **retrospectively**.

Cumulative adjusting entry

Dr: Cost of sales \$10,000 → (P/L) current year (2019)

Dr: R.E^s-opening balance \$20,000 → presented as the first line item just next the beginning R.E of 2019

Cr: Inventories \$30,000

Due to the change in the accounting policy, the carrying values of inventories decreased at 31, Dec, 2018 by \$20,000 *and* at 31, Dec, 2019 by \$30,000. The effect of this decrease in inventory is an increase in the cost of sales of \$10,000 (\$30,000 - \$20,000) for the year-ended 31, Dec, 2019.

Note: *If* the figures for 1, Jan, 2018 were available; the **comparative** statement of P/L would also have been **retrospectively** presented for the **change in accounting policy**. *But* it was **not** presented because 2018 cost of sales **can't** be presented under FIFO due to **impracticability**.

2/5. Required disclosures

A. if the change in accounting policy is voluntary

- A. The **nature** and the **reasons** for the change;
- B. The **reasons** why applying the **new accounting policy** provides more **reliable and relevant** information;
- C. Amount of the **adjustment** for the current period and for each prior period presented;
- D. Amount of the **adjustment** relating to periods prior to those included in the **comparative** information; *and*
- E. The fact that **comparative** information has been **retrospectively restated** *or* that it is **impracticable** to do so and the circumstances that have made **retrospective** application **impracticable**.

B. if the change in accounting policy is made consequent to the enactment of a new IFRS Accounting Standard

- A. The title of the IFRS **Accounting Standard** *or* interpretation;
- B. The fact that the **change in accounting policy** has been made in accordance with the **transitional provisions** of the new/revised standard with a description of those provisions including the effects on future periods;
- C. The **nature** of the change;
- D. The **amount** of the **adjustment** for the current period and for each prior period presented;
- E. The **amount** of the **adjustment** relating to periods prior to those included in the **comparative** information; *and*
- F. The fact that the **comparative** financial information has been **restated** *or* that **restatement** for a particular prior period has not been made because it was **impracticable**.

2/6. Changes in depreciation/amortisation methods

1. Tangible/intangible long-lived assets are subject to depreciation/amortisation respectively *while* a change in depreciation/amortisation method would appear to be a change in accounting policy *but according to IAS #16 and IAS # 38* a change in the depreciation/amortisation methods for existing assets is deemed to be a change in an accounting estimate *and* accounted for **prospectively**.

2. *When* the entity adopts a different depreciation/amortisation method for a **newly acquired** identifiable long-lived tangible/intangible assets and uses that different method for all new assets of the same class *without* changing the method used previously for existing assets of the same class; *Although* this is considered to be a change in accounting policy *but* no retrospective adjustment can be made to comparative F/S^s *and* there is no cumulative effect on R.E^s at the beginning of the earliest period presented, because the different depreciation/amortisation method is applied to the new assets *and accordingly* it would be applied prospectively. In this case a description of the nature of the depreciation/amortisation method changed and the effect on P/L and related per share amounts should be disclosed in the period of the change.

3/1. Accounting estimates and 'Prospective application'

1. The use of **reasonable estimates** is an **essential part** of the F/S^s preparation *due to inherent uncertainties* in business activities *and* does not undermine their **reliability**.

2. **Change in accounting estimate** is an **adjustment** of the **carrying amount** of an asset *or* a liability *or* the amount of the periodic consumption of an asset that results from the **assessment** of the present status of and expected future benefits *and* obligations associated with assets *or* liabilities.

3. **Examples of change in accounting estimate:**

A. **Change in an asset service lives, residual values;**

B. **Change in F.V^s** of financial assets *or* financial liabilities;

C. **Likely collectability of trade receivables** (an estimate of the impairment of receivables *and* related bad debts);

D. **Inventory obsolescence;**

E. **Provision for warranty obligations;**

F. **Provision for pension costs.**

Note: An **impairment** affecting the cost recovery of an asset is **not a change in accounting estimate** *but* is treated as a **loss** of the period.

4. **Changes in estimates** will be highly likely to occur as **new information and more experience** is obtained *or* **circumstances change**. A change in estimate does not warrant **retrospective restating** the F/S^s of the prior periods because it is **not a correction of an error**.

5. IAS # 8 requires that; a change in an accounting estimate is recognised **prospectively** by including the effects of change in P/L in the period of change *if the change affects that period only such as* a change in the % of doubtful accounts; *or* the period of change *and* future periods *if the change affects both such as* a change in estimated economic life of a depreciable asset.

Illustrative example: On 1, Jan, 2015 Falco purchased equipment for \$600,000. It has estimated useful life of ten years *and* a residual value of \$100,000.

On 1, Jan, 2019 Falco decided to review the useful life of the equipment and its residual value. Technical experts were consulted. According to them the **remaining** useful life of the equipment at 1, Jan, 2019 was eight years and its residual value was \$80,000.

Required: Compute the revised annual depreciation for the year 2019 and future years.

Answer:

$$\text{Carrying amount on 1, Jan, 2019} = \$600,000 - \frac{\$600,000 - 100,000}{10 \text{ Years}} \times 4 \text{ years} = \$400,000$$

$$\text{Revised annual depreciation starting from the year-ending 31, Dec, 2019} = \frac{\$400,000 - 80,000}{8 \text{ Years}} = \$40,000.$$

Thus; Prospective application affects current year of change (2019) and future years. All prior period's depreciation would not be **restated** in **comparative F/S**.

6. The effect of a **change in an accounting estimate** should be included in the **same expense classification** as it was used previously for the estimate. This rule helps to **ensure consistency** between the F/S of different periods.

7. According to IAS # 8 when it is difficult to distinguish a **change in an accounting policy** from a **change in an accounting estimate**, the change is treated as a **change in an accounting estimate** with appropriate disclosure. For example a **change** from deferring and amortising a cost to recording it as an expense in the period it incurred because the future benefits of the cost have become doubtful. In this instance the entity is **changing** its **accounting policy** (from deferral to immediate recognition) because of its **change in the estimate** of the future utility of a particular cost incurred currently. **Thus**; it is treated as **a change in an accounting estimate**.

8. Disclosures:

A. An entity should **disclose** the **amounts** and **nature** of **changes in accounting estimates** that has a **material** effect in the current period *or/and* future periods.

B. **If** it is not possible to quantify the amount this **impracticability** should be disclosed.

4/1. Prior period errors

1. **Prior period errors** are omissions from *or* misstatements in F/S^s for one or more **prior periods** arising from a **failure to use *or* misuse** of reliable information that **was available** at the time *when* the F/S^s for those periods were authorised for issue and could reasonably be expected to have been obtained *and* taken into account in the preparation *and* presentation of those F/S^s.

2. **Errors** could result from:

- A. Mathematical mistakes;
- B. Mistakes in applying **accounting policies**;
- C. Oversights;
- D. Misinterpretations of available facts;
- E. Use of unacceptable GAAP; *and*
- F. Fraud.

3. **Error corrections** requires '**retrospective restatement**' *where* prior periods F/S^s must be **restated** to report financial position *and* results of operations as they would have been reported had the **error** never arisen (*unless impracticable* to do so).

4. *When* **correcting** an **error** in prior periods F/S^s, the term '**restatement**' is to be used to effectively communicate to F/S^s users of the **reason** for a particular change in previously issued F/S^s.

5. **Retrospective restatement** is **correcting** the recognition, measurement *and* disclosure of amounts related to elements of F/S^s *as if* a **prior period error** had never occurred.

6. **Materiality** is the major criterion for **retrospective restatement**. **Materiality** depends on the size *and* nature of the omission *or* misstatement judged in the surrounding circumstances.

7. Omissions *or* misstatements of items are **material** *if* they could **individually *or* collectively** influence the economic decisions that users make on the basis of the F/S^s. *If* the **correction** is determined to have a **material** effect on the results of operations *or* the trend of earnings; the F/S^s should be **retrospectively restated**.

8. **Intentional** immaterial **errors** are considered qualitatively **material** *and* require **retrospective restatement**.

9. Changes in **accounting estimates** *and* **errors** are not the same, *where*:

A. Estimates are approximations that may need revision as **additional** information becomes known.

For example the ultimate outcome of a contingency would differ from previously estimated outcome. This does not constitute a **correction of an error** and can't be dealt with by **restatement**. *However* *if* the estimated amount of the contingency had been **miscomputed** from data available *when* the F/S^s were prepared *then*; at least some portion of the variance between the amount accrued *and* the ultimate outcome might reasonably be deemed as an **error**.

B. Errors are omissions from *or* misstatements in the entity's F/S⁵ for one *or* more prior periods discovered in the current period arising from a failure to use *or* misuse of **reliable** information that:

(♦): Was available *when* those prior periods F/S⁵ were authorised for issue, *and*

(♦): Could reasonably be expected to have been obtained *and* taken into account in the preparation *and* presentation of those F/S⁵.

Illustrative example: The financial controller of Nirvana is concerned that some of the payments made this year are significantly larger than the amounts that were provided *and* accrued for. The two largest discrepancies are detailed below:

1. Legal experts had previously advised Nirvana that it would probably be found **not** liable in a court case concerning breaches in employee health and safety legislation. *As such* a **contingent liability** was **disclosed** in the F/S⁵ for the period-ended 30, Sep, 2019. *However* on 1, July, 2020 Nirvana was found liable *and* was ordered to pay damages of \$5m.

2. In its F/S⁵ for the year-ended 30, Sep, 2019 Nirvana **provided for** income tax payable of \$4m. *However* in Jan, 2020, Nirvana's records were inspected by the tax authorities *and* a number of **errors** were discovered. The tax authorities recommended that Nirvana improve its controls *and* training to prevent such mistakes from happening again. Nirvana was not levied with any fines *but* the authorities deemed that the correct amount of tax payable on profits earned in the period-ended 30, Sep, 2019 was \$5.50m. Nirvana paid this in July, 2020.

Required: Discuss the correct accounting treatment of the above transactions for the year-ended 30, Sep, 2020.

Answer: IAS # 8 '**Accounting policies, changes in accounting estimates and errors**' says that; a **prior period error** is a misstatement in prior year's F/S⁵ *resulting from* the misuse of information which should have been taken into account. **Prior period errors** are **adjusted** for by **retrospective restatement** of **comparative** amounts.

Changes in accounting estimates are accounted for **prospectively** by including the impact in P/L in the current period and *where relevant*, future periods.

1. **The court case:** This is **not** a **prior period error** because Nirvana had based its accounting treatment on the best information available. The payment of \$5m will be **expensed** to P/L in the year-ended 30, Sep, 2020.

2. **Tax:** The mistakes made in the F/S⁵ for the year-ended 30, Sep, 2019 should **not** have been made based on the information available to Nirvana. This *therefore* satisfies the definition of a **prior period error**. In the F/S⁵ for the year-ended 30, Sep, 2019 the current tax expense *and* the income tax payable should both be increased by \$1.50m on a **retrospective basis**.

10. An entity should correct **material prior period error retrospectively** in the first set of the F/S⁵ authorised for issue after their discovery by:

A. **Restating** the **comparative** amounts for the **prior periods** presented in which the **error** occurred.

B. *If* the **error** occurred **before** the earliest prior period presented; the **opening balances** of assets, liabilities *and* R.E⁵ for the earliest prior period presented is **restated**.

11. IAS # 1 was amended to require presentation of **two comparative SFP** *where* there is a **restatement as a result of an error**.

4/2. 'Retrospective restatement'

Illustrative example: Assume that Dragon had **overstated** its depreciation expense by \$60,000 for the year-ended 30, Sep, 2018 and \$90,000 for the year-ended 30, Sep, 2019 both *due to* mathematical **mistakes**. The **errors** affected both the F/S^s and the income tax returns in the respective years and are discovered in 2020. Assume that only one **comparative** SFP is given. Dragon's SFP and statements of CI and R.E^s for the year-ended 30, Sep, 2019 prior to the **restatement** were as follows:

Statement of P/L and R.E ^s Prior to restatement	
Year-ended 30, Sep, 2019	
Description	Amount
Sales	\$3,000,000
Cost of sales	(1,400,000)
Gross profit	1,600,000
Depreciation expense	(490,000)
Distribution cost and administrative expenses	(510,000)
Profit from operations	600,000
Other income	10,000
Profit before income taxes	610,000
Income taxes (20%)	(122,000)
Net profit	488,000
Beginning R.E^s	4,200,000
Dividends	(300,000)
Ending R.E ^s	4,388,000

SFP prior to restatement 30, Sep, 2019	
Description	Amount
Assets	
Non-current assets	
PPE-cost	\$4,200,000
Acc. Dep	(1,430,000)
Net carrying value	2,770,000
Current assets	3,520,000
Total assets	6,290,000
Stockholders' equity and liabilities	
Shareholders' equity	
Ordinary shares	1,300,000
R.E ^s	4,388,000
Total shareholders' equity	5,688,000
Non-current liabilities	270,000
Current liabilities	
Income taxes payable	120,000
Other current liabilities	212,000
Total current liabilities	332,000
Total liabilities	602,000
Total stockholders' equity and liabilities	6,290,000

Required: Restate prior period F/S^s.

Answer:

A. **Adjust** the carrying amounts of assets *and* liabilities at the **beginning** of the first period presented (1, Oct, 2018) in the F/S^s for the **cumulative effect** of the **correction** related to periods prior to those presented. with the offsetting effect is reflected in the **opening balance** of R.E^s

Adjusting entry to the beginning R.E^s of the first period presented (1, Oct, 2018):

Dr: Acc. Dep \$60,000

Cr: Income tax payable ($\$60,000 \times 20\%$) = \$12,000

Cr: R.E^s ($\$60,000 \times 80\%$) = \$48,000

B. **Adjust** the F/S^s of each **individual** prior period presented (year-ended 30, Sep, 2019) for the effects of **correcting** the error on that **specific period** (referred to as the **period specific effects** of the **error**). The F/S^s are presented *as if* the error had never occurred. The **restated** F/S^s are presented below.

Statement of P/L and R.E ¹ as Restated	
Year-ended 30, Sep, 2019	
Description	Amount- restated
Sales	\$3,000,000
Cost of sales	(1,400,000)
Gross profit	1,600,000
Depreciation expense	(400,000)
Distribution cost <i>and</i> administrative expenses	(510,000)
Profit from operations	690,000
Other income	10,000
Profit before income taxes	700,000
Income taxes (20%)	(140,000)
Net profit	560,000
Beginning R.E ¹ as originally reported	4,200,000
Add: Restatement to reflect correction of an error in depreciation expense	48,000
Beginning Restated R.E ¹	4,248,000
Dividends	(300,000)
Ending R.E ¹	4,508,000

SFP at 30, Sep, 2019 as Restated	
Description	Amount- restated
Assets	
Non-current assts	
PPE-cost	4,200,000
Acc. Dep	(1,280,000)
Net carrying value	2,920,000
Current assets	3,520,000
Total assets	6,440,000
Stockholders' equity <i>and</i> liabilities	
Shareholders' equity	
Ordinary shares	1,300,000
R.E¹	4,508,000
Total shareholders' equity	5,808,000
Non-current liabilities	270,000
Current liabilities	
Income taxes payable	150,000
Other current liabilities	212,000
Total current liabilities	362,000
Total liabilities	632,000
Total stockholders' equity and liabilities	6,440,000

C. The following entry reflects the effect of the **restated** F/S^s for the year-ended 30, Sep, 2019:

Dr: Acc. Dep \$90,000

Cr: Income tax payable ($\$90,000 \times 20\%$) = \$18,000

Cr: R.E^s ($\$90,000 \times 80\%$) = \$72,000

4/3. Impracticability exception

1. According to IAS # 8; when it is **impracticable** to determine the cumulative effect of a prior period's **error**, the entity presents the **comparative** information **retrospectively** only to the extent that it is practicable *as if* the **error** had been corrected from the **earliest date practicable**.
2. **Impracticability exception** is not an invitation to not **restate comparative F/S** of the prior periods to remove the effects of **errors**. IAS # 8 sets out strict criteria of what constitutes **impracticability**.

4/4. Disclosures

When an accounting **error** is being **corrected** the entity is to **disclose** the following:

1. The fact that the F/S^s have been **restated**;
2. The nature of the prior-period **error**;
3. The amount of the **correction** for each prior period presented;
4. The amount of the **correction** relating to periods prior to those presented in **comparative F/S^s**;
5. The effect of the **restatement** on each line item in the F/S^s;
6. The cumulative effect of the **restatement** on R.E^s;
7. If **retrospective restatement** is **impracticable** for a particular prior period; the circumstances that led to the existence of that condition should be disclosed.

These **disclosures** need **not** be repeated in subsequent periods

Illustrative example: In its 2019 annual accounts Gobles included the **corrected** 2018 consolidated cash flow figures as the **comparative** numbers to the 2019 consolidated cash flow statement. The 2019 F/S^s did **not** include any reference to the fact that the **comparative** numbers accompanying the 2019 cash flow statement had been **corrected**. Gobles had issued a communication to the market about the **changes**.

Required: Discuss the implications of the above event.

Answer: The **changes** to the **comparative** figures were **material errors** and should have been **adjusted** in accordance with IAS # 8 and supported by the relevant **disclosures** which would have included **disclosure of** the nature of the prior period **errors**. Even if the **corrections** to the 2018 cash flow statement had been adequately communicated to the market *through* an announcement; **further disclosures** were necessary in the 2019 notes.

IAS # 1 state that; in **virtually all circumstances** a **fair presentation** is achieved by compliance with **applicable IFRS Accounting Standard**. The fact that relevant information has already been communicated to the market does not release Gobles from the obligation to apply IFRS **Accounting Standard** when preparing its annual accounts. A press announcement can't stand in the place of information that is required to be **disclosed and** audited within a set of annual F/S^s.

1/1. Examinable syllabus guide for

DECEMBER 2024 TO JUNE 2025 according to ACCA

Operating segments

- Discuss the usefulness and problems associated with the provision of segment information.
- Define an operating segment.
- Identify reportable segments (including applying the aggregation criteria and quantitative thresholds).

After studying our material and solving related questions, please refer back to the points above to make sure you fully cover it well.

1/2. The need of segment reporting

1. Although traditional aggregated F/S^s enable users to assess the overall financial health of the entity but it fails to give them relevant details about the entity's individual operations and its economic environment in which each component operates. For example diversified and multinational entities produce a wide range of products/services, often in several different countries subject to different risks, rewards, opportunities for growth and future prospects.

So further information on how the overall results of these entities are made up from each of these products/services or geographical areas will help F/S^s users to understand the entity's past performance and better assess the entity's risks and returns for each component enabling them to make more informed judgements about the entity as a whole.

Accordingly; Segment reporting is designed to reveal significant information that might be hidden by aggregated F/S^s.

Things we see from here are different from things we see from there

2. A business segment is a distinguishable component of an enterprise which provides an individual product or service (or group thereof) that is subject to different risks and returns from the other business segments.

3. IFRS Accounting Standard # 8 'Operating Segments' was issued on Nov, 2006 as part of the IASB's program of convergence with US GAAP. IFRS Accounting Standard # 8 superseded IAS # 14 'Segment reporting'. IFRS Accounting Standard # 8 is essentially the same as the U.S statement of financial accounting standard (SFAS) # 131 'Segment reporting'.

4. Scope of IFRS Accounting Standard # 8:

A. IFRS Accounting Standard # 8 applies to separate and consolidated F/S^s of listed entities whose securities are publically traded.

Notes:

- When a listed parent issues both separate and consolidated F/S^s; segment information is required only in the consolidated F/S^s.

- If a non-public entity voluntarily discloses segment information; it must comply with IFRS Accounting Standard # 8 in all respects or the information presented in its F/S^s can't be described as 'segment information'.

B. IFRS Accounting Standard # 8 sets three alternative quantitative thresholds; one must be met for an operating segment to qualify as a reportable segment.

C. IFRS Accounting Standard # 8 sets out disclosures required for each reportable segment and also require general and entity-wide disclosures to reveal masked information in aggregated F/S^s.

5. The core principle of IFRS Accounting Standard # 8 is the disclosure of information that enable F/S^s users to evaluate the nature and financial effects of the individual business activities of the entity and the economic environment in which it operates allowing them to understand the entity's main activities, where those activities are located and how well those activities are performing and making meaningful comparisons to prior periods.

2/1. Identify operating segments

An **operating segment** is a **component** of an entity with the following three key features:

- A. Engages in business activities from which it may earn **external or internal** revenues and incur expenses; *and*
- B. Its **operating results** are **regularly reviewed** by a **chief operating decision maker (CODM)** who has power to make decisions about resources to be allocated to the segment and assess its performance, *and*
- C. For which **discrete financial information** is available to facilitate its performance review.

From the above features the following can be noted:

1. **Chief operating decision maker (CODM)** is a **function** not a manager with a specific title. That function has supervisory authority to allocate resources to the **operating segments** *and* assesses its performance.
2. CODM could be an **individual** *such as* chief executive officer (CEO) *or* chief operating officer (COO) *or* it may be a **group** of executive directors *or* executive committee.
3. *Where* the board of directors (BOD^s) include some **non-executive** directors it may **not** be appropriate to classify the BOD^s as the CODM because **non-executive** directors have governance role not a management role. They are **not involved** in the day-to-day activities *therefore* they do **not take decisions** *regarding* resource allocation.

Illustrative example: Franz is a **listed** entity. It has four **major** lines of business; manufacturing, retail, real estate *and* entertainment. Each major line of business has a COO who is responsible for the **business component's** profitability. The entity has a CEO who is in charge of the **entire business** of the entity *and* reports to the BOD^s on the results of operations. The CEO has the authority from the Board to **decide on the performance bonus of each COO** for which the CEO has set key performance indications (KPI^s) against which they are evaluated each year by the CEO. **Discrete financial information** for each major line of business is **available**. The CEO has been entrusted by the Board to **allocate funds** for the day-to-day operations of the four lines of business which he does based on **criteria** *such as* their comparative profitability, size of business generated *and* cash flows from operations.

Required: Based on the previous facts about the functioning of Franz *and* other relevant information provided. Who is the CODM for the purposes of IFRS **Accounting Standard # 8**? Is it the Board, the CEO or each COO for the line of business he or she is responsible for?

Answer: CODM has power to **make decisions** about resources allocation to the segment *and* assess its performance. CODM is a **function** not a manager with a specific title. The CODM could be an **individual** *or* a **group** of executive directors *or* executive committee.

A. The COO of each line of business is only responsible for the results of the line of business he or she is responsible for *but* is **not responsible** for the **overall business** of the entity. *Thus*; each COO can't qualify as the CODM.

B. *While* the Board is the highest authority in the hierarchy; the CEO has been **given the required powers** by the Board including the **power of resources allocation** *and* the **power to assess the performance** of the four business lines of the entity. According to the requirements of IFRS **Accounting Standard # 8**, the CODM is **not** the Board *but* is the CEO.

4. Under IFRS Accounting Standard # 8, revenue generation is not an absolute measure for an operating segment. Some operating segments may derive their revenue solely or primarily from other segments of the same entity and if they meet other requirements to qualify as operating segments, these segments can qualify as operating segments. Thus, under IFRS Accounting Standard # 8 the operating segment is not required to have revenues generated from external customers in order to be classified as an operating segment for financial reporting purposes.

Illustrative example: Centrica is a publicly listed auto dealership entity. Based on the decision of the BOD^s Centrica is managed and controlled through three divisions. Spare parts division, workshop division and sales division. Both the sales division and the workshop division deal with external customers and handle orders of both walk-in customers as well as long-term customers who have purchased automobiles through this dealership. The entity's spare parts division only supplies spare parts to its workshop division and does not respond to the demands of any outside customers. The outside customers can't purchase spare parts directly from the spare parts division unless their vehicles are serviced by the workshop division and the workshop division purchases spare parts from spare parts division for the purposes of undertaking repairs of cars they have been contracted to undertake repair work for.

The CODM is the BOD^s who allocates resources and assesses performance based on the results of the three divisions for which the entity's financial controller maintains separate and discrete financial information.

Required: Under IFRS Accounting Standard # 8 how many operating segments do Centrica have?

Answer: IFRS Accounting Standard # 8 states that; some operating segments may derive their revenue solely or primarily from other segments of the same entity and if they meet other requirements to qualify as operating segments; these segments can qualify as operating segments and reporting on the grounds that they do not derive their revenues from external sources. Thus, under IFRS Accounting Standard # 8 a segment is not required to have revenues generated from external customers in order to be classified as an operating segment for financial reporting purposes. Therefore under IFRS Accounting Standard # 8 all three divisions of Centrica qualify as operating segments.

5. Under IFRS Accounting Standard # 8, the following business components may qualify as operating segments:

- A. Start-up operations even if that component of the entity is not yet earning any revenues from its operations;
 - B. A discontinued operation if it continues to engage in business activities, its operating results are still regularly reviewed by the CODM and there is discrete financial information available to facilitate its performance review;
 - C. External R&D operation can qualify as an operating segment if it provides material revenues. While; internal R&D is not an operating segment;
 - D. A functional department can qualify as an operating segment if it relates to line position such as selling or manufacturing departments (i.e. not staff position such as H.R or accounting department);
 - E. In situations where all or most of the segment's revenues and expenses are derived from inter group transactions these segments may qualify as operating segments (vertically integrated organisations).
6. According to IFRS Accounting Standard # 8 not every part of the entity is necessarily an operating segment or part of an operating segment for example:
- A. Corporate headquarters (head office) is not an operating segment because it is not engaged in business activities (does not earn revenue or incur expenses in the ordinary course of business);
 - B. Certain functional departments that earn no revenues or generate incidental revenues relative to the activities of the entity as a whole such as the entity's cafeteria.
 - C. An entity's postemployment benefit plans including pension plan.

7. The identification of **operating segments** within entities has grown in complexity over the years especially in conglomerates that has 'matrix organisational structures' where the internal managerial information system may generates reports in which business activities are presented in a variety of ways. For example the CODM uses information based on product or service and at the same time information based on geographical areas to review business activities.

The following matrix shows the entity's information system ability to present performance reports based on *either* products or geographical areas:

Products↓	Geographical areas →					Total
	G ₁	G ₂	G ₃	G ₄	G ₅	
P ₁	\$XX	\$XX	\$XX	\$XX	\$XX	\$XX
P ₂	XX	XX	XX	XX	XX	XX
P ₃	XX	XX	XX	XX	XX	XX
P ₄	XX	XX	XX	XX	XX	XX
P ₅	XX	XX	XX	XX	XX	XX
Total	XX	XX	XX	XX	XX	XX

Under these situations, the entity's management must identify a **single set** of business components on which to base the segment disclosures. The basis chosen should be the one that best enables F/S' users to understand the business and the environment in which it operates.

Accordingly; the definition of an **operating segment** under IFRS Accounting Standard # 8 is based on the entity's internal managerial reporting system that could be substantially different among entities in the **form and content** of the reports and information reviewed by the CODM in each entity.

Thus; IFRS Accounting Standard # 8 adopts a **management approach** (not 'risks and rewards' approach) in determining operating segments. Accordingly the definition of an **operating segment** under IFRS Accounting Standard # 8 is based on the entity's **business model** which could be significantly different from entity to entity → disadvantage.

8. **Segment reporting** by the entity should be consistent overtime to the extent possible in order to ensure **comparability** of disclosures from period to period.

2/2. Operating segments aggregation criteria

Two or more operating segments may **optionally** be aggregated into a single operating segment *if*:

1. The operating segments have similar economic characteristics *such as* similar expected long-term average gross margins; *and*
2. The operating segments are similar in each of the following aspects:
 - A. The nature of the products *and* services;
 - B. The nature of the production processes;
 - C. The type *or* class of customer for their products *and* services;
 - D. The methods used to distribute their products *or* provide their services; *and*
 - E. *If applicable*, the nature of the regulatory environment, for example banking, insurance *or* public utilities.

Thus, IFRS Accounting Standard # 8 sets **strict criteria** for aggregation to prevent entities from inappropriate over-aggregating operating segments that could mask relevant detailed information.

Illustrative example: Bono is a French based entity that sells video games *and* hardware. Sales are made through the entity's website *as well as through* high street stores. The products sold online *and* in the stores are the same. Bono sell new releases of video games for €100 in its stores *but* for €80 online.

Internal reports used by the CODM show the results of the online business **separately** from the stores.

Required: Should the online business *and* the high street stores be aggregated into a single operating segment?

Answer: IFRS Accounting Standard # 8 says that; two or more operating segments may be **optionally** aggregated into a single operating segment *if*:

1. The operating segments have similar economic characteristics *such as* similar expected long-term average gross margins; *and*
2. The operating segments are similar in each of the following aspects:
 - A. The nature of the products *and* services;
 - B. The nature of the production processes;
 - C. The type *or* class of customer for their products *and* services;
 - D. The methods used to distribute their products *or* provide their services; *and*
 - E. *If applicable*, the nature of the regulatory environment, for example banking, insurance *or* public utilities.

♦ IFRS Accounting Standard # 8 says that; operating segments with similar economic characteristics would have similar long-term gross margins. Bono sells its product at different sales prices between the stores and the online business giving rise to significant differences in gross margins. This suggests dissimilarity in terms of economic characteristics.

♦ Bono stores and online business sell the same types of product and there are likely to be no major differences in the types of customer (individual consumers). Therefore in these respects, the operating segments are similar.

However customers will collect their goods from the stores but Bono will deliver the products sold online. This means that distribution methods are different.

Thus: it might be more appropriate to not aggregate these operating segments.

Note: For exam purposes; it is important to state the relevant aggregation criteria and then to apply these criteria to the information given in the question.

2/3. **Not** all operating segments would automatically qualify as

Reportable segments

Although IFRS Accounting Standard # 8 does not specifically define **reportable** segments but it states that: a **reportable segment** is an **operating segment** or aggregations of two or more of such **operating segments** that:

1. Has been identified as meeting the definition of an **operating segment**; and
2. Meets **any one** of the following **alternative** quantitative thresholds:
 - A. The segment's **combined revenue** (internal and external) is 10% or more of the **combined revenue** (external and intersegment) of all **operating segments**; or
 - B. The absolute amount of its reported **profit or loss** is 10% or more of the greater of:
 - (i): The **combined** reported **profit** of all **operating segments** that did not report a loss, and
 - (ii): The **combined** reported **loss** of all **operating segments** that reported a **loss**.
 - C. Its **assets** are 10% or more of the **combined assets** of all **operating segment**.

Only reportable segments give rise to the F/S^s disclosures set forth by IFRS

Accounting Standard # 8

Illustrative example: Below are details of the **operating segments** data that is provided to the CODM.

Segment	Total sales (revenue)	Profit	Loss	Assets
A	\$600,000	\$280,000	-	\$400,000
B	450,000	-	\$290,000	1,200,000
C	2,000,000	-	1,110,000	1,300,000
D	700,000	-	400,000	500,000
E	600,000	220,000	-	900,000
F	3,200,000	2,500,000	-	1,200,000
Combined	7,550,000	3,000,000	1,800,000	5,500,000

Required: Which of the previous operating segments represents a **reportable** segment?

Answer: A **reportable segment** is an **operating segment** or aggregations of two or more of such operating segments that:

1. Has been identified as meeting the definition of an operating segment; and

2. Meets **any one** of the following **alternative** quantitative thresholds:

A. The segment's **combined revenue** (internal and external) is 10% or more of the **combined** revenue (external and intersegment) of all operating segments; i.e. $7,550,000 \times 10\% = \$755,000$ or

B. The absolute amount of its reported **profit or loss** is 10% or more of the greater of:

(i): The **combined** reported **profit** of all operating segments that did not report a loss i.e. \$3m, and

(ii): The **combined** reported **loss** of all operating segments that reported a loss i.e. \$1.80m.

Thus; the 10% is based on \$3m i.e. \$300,000;

C. Its **assets** are 10% or more of the **combined assets** of all operating segment i.e. $\$5.50 \text{ m} \times 10\% = \$550,000$.

Segment	Total sales	Profit/Loss	Assets	Reportable segment
A	No	No	No	No
B	No	No	Yes	Yes
C	Yes	Yes	Yes	Yes
D	No	Yes	Yes	Yes
E	No	No	Yes	Yes
F	Yes	Yes	Yes	Yes

Conclusion: All operating segments *but* (A) are reportable segments.

2/4. 'Minimum' 75% test

If the total **external revenue** reported by the identified **operating segments** that qualify as reportable segments are less than 75% of the entity's **external revenue**; additional **operating segments** must be identified as reportable segments *until* the **external revenues** of the reportable segments reaches at least to 75% of the entity's **external revenue** *even if* they do not meet the 10% quantitative thresholds.

Thus; IFRS **Accounting Standard # 8** relaxed its requirements of meeting the 'alternative 10% quantitative thresholds' criteria *until* this minimum limit are reached.

Illustrative example (1): The management of Rivera 'a **listed entity**' identifies **operating segments** based on geographical location. Information for these segments is provided below:

Segment	Total Revenue	External Revenue	Internal Revenue	Profit/Loss	Assets
Europe	\$260	140	120	98	3,400
Middle East	78	33	45	(26)	345
Asia	150	150	0	47	995
North America	330	195	135	121	3,800
Central America	85	40	45	(15)	580
South America	97	54	43	10	880
Totals	1,000	612	388	235	10,000

Required: According to IFRS **Accounting Standard # 8**; determine the reportable segments.

Answer:

Segment	10% test based on combined revenue \$1,000	10% test based on combined reported profit \$276	10% test of based on combined assets \$10,000	Reportable segments
Europe	Yes	Yes	Yes	Yes
Middle East	No	No	No	No
Asia	Yes	Yes	No	Yes
North America	Yes	Yes	Yes	Yes
Central America	No	No	No	No
South America	No	No	No	No

Note: For **profit or loss** test:

A. The absolute combined profits of all **operating segments** that did not report a **loss** is \$276.

B. The absolute combined **loss** of all **operating segment** that reported a **loss** is \$41.

Thus; **profit or loss** test is based on \$276.

Based on the 10% tests Europe, Asia and North America are reportable. However we must check whether they comprise at least 75% of Rivera's **external revenue**.

75% test	
Segment	External revenue
Europe	\$140
Asia	150
North America	195
Totals	485

The **external** revenue of reportable segments is 79% of total **external** revenue (\$485/ \$612). Thus, the **75% test** is met *and* no other segments need to be reported.

Conclusion: The reportable segments are Europe, Asia *and* North America.

Note: Geographical segments may be based on the location of the entity's operations (by **source**) *or* on the location of the entity's markets (by **destination**).

Illustrative example (2): Zola is a **listed** entity. The BOD^s is responsible for all key **financial and operating decisions** including the **allocation of resources**. The BOD^s receive a monthly report on the activities of the five significant operational areas of Zola based on **product line**. Relevant financial information relating to the five product lines for the year to 30, Sep, 2020 *and* in respect of the head office is as follows:

Operating segment (Product line)	External revenue for year to 30, Sep, 2020	Profit/(loss) for year to 30, Sep, 2020	Assets at 30, Sep, 2020
(1)	\$23,000	\$3,000	\$8,000
(2)	18,000	2,000	6,000
(3)	4,000	(3,000)	5,000
(4)	2,000	150	500
(5)	3,000	450	400
Subtotal	50,000	2,600	19,900
Head office	0	0	6,000
Entity total	50,000	2,600	25,900

Required: Which of the above product lines should report separate information (considered **reportable segments**)?

Assuming product lines (1), (2) *and* (3) exhibit very distinct economic characteristics *but* the economic characteristics of product lines (4) *and* (5) are very similar

Answer:

1. For operating segments that have very similar economic characteristics:

If product lines (4) *and* (5) meet all of the **aggregation criteria**; they will be considered as a **single operating segment**.

2. Identifying reportable segments:

Operating segment (Product line)	External revenue		Profit/(loss)		Assets		Reportable segments
	Amount	%	Amount	%	Amount	%	
(1)	\$23,000	46%	\$3,000	53.60%	\$8,000	30.90%	Yes
(2)	18,000	36%	2,000	35.70%	6,000	23.20%	Yes
(3)	4,000	8%	(3,000)	53.60%	5,000	19.30%	Yes
(4) <i>and</i> (5)	5,000	10%	600	10.70%	900	3.50%	Yes
Head office	0	N/A	0	N/A	6,000	N/A	
Entity total	50,000		2,600		25,900		
Test denominator	50,000	100%	5,600		25,900	100%	

Notes:

1. The head office does not meet the definition of an operating segment because it is not engaged in business activities and it does not earn revenue or incur expenses.

2. Although the head office does not satisfy operating segment definition but its assets are included for the asset test.

3. For profit or loss test:

A. The absolute combined profits of all operating segments that did not report a loss is \$5,600.

B. The absolute combined loss of all operating segment that reported a loss is \$3,000.

Thus, profit or loss test is based on \$5,600.

3. The 75% Test

The total external revenues of the reportable segments constitute 100% of the total external revenue. (\$50,000/\$50,000). Thus, the 75% minimum threshold for external revenue test is satisfied. Accordingly no additional operating segments need be identified as reportable segments.

Illustrative example (3): Roma is a listed entity. The CEO is responsible for all key financial and operating decisions including the allocation of resources. The CEO receives a quarterly report on the activities of the five significant operational areas of Roma based on product line. Relevant financial information relating to the five product lines for the year to 30, June, 2020 is as follows:

Operating segment (Product line)	External revenue for year to 30, June, 2020	Profit/(Loss) for year to 30, June, 2020	Assets at 30, June, 2020
(1)	\$4,800	\$194	\$100
(2)	4,900	(180)	200
(3)	4,700	(150)	300
(4)	4,600	(70)	400
(5)	31,000	1,806	4,000
Total	50,000	1,600	5,000

Required: Which of the above operating segments (product lines) should report separate information (considered reportable segments)?

Answer:

1. Identifying reportable segments:

Operating segment (Product line)	External revenue		Profit/(Loss)		Assets		Reportable segments
	Amount	%	Amount	%	Amount	%	
(1)	\$4,800	9.60%	\$194	9.70%	\$100	2%	No
(2)	4,900	9.80%	(180)	9%	200	4%	No
(3)	4,700	9.40%	(150)	7.50%	300	6%	No
(4)	4,600	9.20%	(70)	3.50%	400	8%	No
(5)	31,000	62%	1,806	90.30%	4,000	80%	Yes
Total	50,000	100%			5,000	100%	

Note: For profit or loss test:

A. The absolute combined profits of all operating segments that did not report a loss is \$2,000.

B. The absolute combined loss of all operating segment that reported a loss is \$400.

Thus; profit or loss test is based on \$2,000.

2. The 75% test:

The total external revenue of the reportable segments is \$31,000 which represents only 62% of Roma's external revenue (\$31,000/ \$50,000). Thus; the 75% minimum threshold for external revenue test is not satisfied. Accordingly; additional operating segments must be identified as reportable segments until total external revenue of the reportable segments reaches at least to 75% of Roma's external revenue even if they do not meet the 10% quantitative thresholds.

From above information; operating segment (2) is the nearest segment to satisfy the 10% of any of the three tests. The external revenue of the operating segment (2) is \$4,900.

The total external revenue of the reportable segments would be \$35,900 (\$31,000 + \$4,900) which represents only 71.80% of the total external revenue (\$35,900/ \$50,000).

Again we need additional operating segments to satisfy the 75% minimum test. Operating segment (1) is the second nearest segment to satisfy the 10% based on profit or loss test. The external revenue of the operating segment (1) is \$4,800. The total external revenue of the reportable segments would be \$40,700 (\$31,000 + \$4,900 + \$4,800) which represents 81.40% of the total external revenue (\$40,700/ \$50,000). Accordingly no additional operating segments need be identified as reportable segments.

2/5. The remaining operating segments

After the 'Minimum' **75% test** is satisfied, for the remainder operating segments check *whether* any of the previously identified operating segments *or* aggregated operating segments meets the **majority** of the aggregation criteria. *If* they do, aggregate them *and* are treated as a reportable segments ***if desired***.

Notes:

A. Individual operating segments can also be treated as reportable segments *even if* they are not aggregated with another segment *or* do not meet the quantitative threshold; *if* management believes that information about the segment would be useful to the F/S^s users.

B. Although IFRS Accounting Standard # 8 did not determine the number of reportable segments *but* a practical limit could be 10 in order to avoid information overload to F/S^s users.

2/6. 'All other segments' category

1. Information about other immaterial business activities and operating segments that are not reportable are combined into an 'all other segments' category and presented in a single column. Thus, a catch-all ('all other segments') category should not be used unless truly immaterial.
2. 'All other segments' category is not a reportable segment as defined by IFRS Accounting Standard # 8.
3. The sources of the revenue included in the 'all other segments' category must be described.

Summary of steps in the determination of reportable segments:

1. Identify operating segments based on management internal reporting system;
2. Determine whether any operating segment meets all aggregation criteria and if so, aggregate them if desired;
3. Review the identified operating segments and aggregated groups of operating segments to determine if each meet at least one of the quantitative thresholds (10% thresholds) to be treated as a reportable segment;
4. Test whether the external revenues of the identified reportable segments so far represent 75% or more of the entity's total external revenue. If the total external revenue of reportable segments is less than 75% of the total entity's external revenue, then report additional operating segments regardless of 10% quantitative thresholds;
5. For the remainder, check whether any of the previously identified operating segments or aggregated groups of operating segments meet the majority of the aggregation criteria. If they do, aggregate them as a reportable segment if desired.
6. Individual operating segments can also be treated as reportable segments even if they are not aggregated with another segment or do not meet the quantitative threshold if management believes that information about such operating segment would be useful to the F/S^s users.
7. Finally, aggregate the remaining segments into a category called 'all other segments'. A catch-all ('all other segments') category title should not be used unless truly immaterial.

3/1. Other relevant points

1. IFRS Accounting Standard # 8 establishes how the entity report information about its **reportable segments** in its **annual F/S^s and interim reports**.

2. IFRS Accounting Standard # 8 requires each entity to report **financial and descriptive** information about its **reportable segments** on the **same basis** the information presented to **CODM**. This approach would leads to putting users in the 'shoes of management' in their ability to evaluate management performance (i.e. See through the eyes of management). *Accordingly*; **segment reporting varies** substantially from entity to entity depending on its **internal structure of the information reporting system**. This would **impair** the F/S^s user's ability to **compare disclosures regarding reportable segments** among entities.

Illustrative example: IFRS Accounting Standard # 8 states that; the entity should report (consider the **operating segment** as a **reportable segment**) an **operating segment's** internal *and* external revenues *if* its **combined revenue** comprises at least 10% of the **combined internal and external revenue** of '**all operating segments**'.

Required: What is meant by '**all operating segments**' stated above?

Answer: '**All operating segments**' means the total revenues of all **operating segments** reviewed by the **CODM**. The total **revenues** of all **operating segments** reviewed by the **CODM** not necessarily equal the total of consolidated revenues reported in the F/S^s of the entity because information reported to the **CODM** for **performance evaluation and resource allocation** could be greatly different from information reported under IFRS Accounting Standards *and* it differs from entity to entity.

3. Information that is not prepared for internal use by the **CODM** need **not** be reported *if* it is **not** available *and/or* the cost to develop it would be excessive.

4. *If* an **operating segment** is identified as a **reportable segment** in the current period; **comparative segment data** for prior period should be **presented retrospectively unless** the prior period **comparative** information is **not** available *and/or* the cost to develop it would be excessive.

4/1. **Problems with IFRS Accounting Standard # 8**

Segment reporting provides useful information *but* also has **limitations** as follows:

1. Trading between segments may distort the results of each **operating segment** *particularly if* the transactions do not occur at F.V.
2. IFRS **Accounting Standard # 8** states that; segments should reflect the way in which the entity is managed. This means that; **segment information** is **only** useful for **comparing** the performance of the same entity over time *but not* for **comparing** the performance of different entities.
3. The segmentation process is based on **management's perspective** *and* some users lack trust in management's intentions. For example management may attempt to **conceal loss-making areas** of the business within a larger profitable **reportable segment**.
4. The guidance around the **aggregation of operating segments** is **vague** *and* may lead to entities **over-aggregating** segments to **reduce the level of detail** that they are required to report.
5. **Common costs** may be **allocated** to different segments on *whatever* basis the directors believe is reasonable. This can lead to **arbitrary allocation** of these costs to **overshadow** segment results.
6. The **materiality threshold** for an **operating segment** to **qualify** as a **reportable segment** is basically set at one which contributes at least 10% of **combined revenue, profits/ loss or total assets**. Even with this guidance *however* **segment identification** is a somewhat **subjective exercise** *and* **comparisons** of segment information provided by different entities could be misleading.

5/1. **Critical comments to IFRS Accounting Standard # 8**

IFRS Accounting Standard # 8 was introduced as part of the IASB's program of convergence with US GAAP. It replaced IAS # 14. IFRS Accounting Standard # 8 is essentially the same as the FASB standard on segment reporting (SFAS #131). It was felt by many European users that IFRS Accounting Standard # 8 was indeed easier than IAS # 14 for entities to prepare *but* at the cost of promoting a **lower quality** of financial reporting.

The **central criticisms** of IFRS Accounting Standard # 8 are that;

1. IFRS Accounting Standard # 8 gives management **too much discretion** over how segment results are reported. The former IAS # 14 required entities to decide which segments were **reportable** on the basis of segment's **risks and returns** *but* IFRS Accounting Standard # 8 allows entities to report segments based on **internal organisation structure** alone.
2. IFRS Accounting Standard # 8 **reduced** the level of **compulsory disclosures** which is likely to **reduce the usefulness** of the information provided to users. Only a segment's **profit or loss** together with its **total assets** needs to be disclosed.
3. IFRS Accounting Standard # 8 eliminates the previous requirement under IAS # 14 to report on both **primary and secondary segments** which clearly *results in less* information being reported.

1/1. Examinable syllabus guide for
DECEMBER 2024 TO JUNE 2025 according to ACCA

Inventories

- Measure and value inventories.

After studying our material and solving related questions, please refer back to the points above to
make sure you fully cover it well.

1/2. Overview

IAS # 2 'Inventories' prescribes:

- A. The accounting treatment for **inventories**;
- B. **Measuring** the cost to be recognised as an asset'
- C. **Cost flow assumptions** ('cost formulas');
- D. **Write-down of inventory** to its net realisable value (**NRV**);
- E. **Reversals** of previously recognised write-down; *and*
- F. Inventory **disclosures**.

1/3. Scoped out

IAS # 2 does not apply to:

1. **Work in progress under construction contracts** (covered under IFRS Accounting Standard # 15 'Revenue from contracts with customers');
2. **Financial instruments** (covered under IFRS Accounting Standard # 9 'financial instruments');
3. **Biological assets at the point of harvest** (covered under IAS # 41 'Agriculture');
4. Gold in central bank.

1/4. Components of inventories

Inventory is a current asset that composed of:

- A. Items **purchased** *and* held for resale (merchandise);
- B. Finished goods **produced**;
- C. Work in progress (WIP); *and*
- D. Materials *or* supplies to be consumed in production process *or* in rendering of services.

2/1. Inventory actual cost components

Under IAS # 2 inventory is measured at **actual costs**.

Actual costs of inventories include all of the following:

1. Purchasing costs

Purchase costs include:

Purchase price;

Plus: Import duties;

Plus: Irrecoverable taxes;

Plus: Transportation in;

Plus: Handling costs;

Plus: Any other cost directly pertaining to the acquisition of the goods or materials;

Minus: Trade discounts;

Minus: Rebates.

Illustrative example: Goody purchases motorcycles from various countries *and* exports them to China.

Goody has incurred the following expenses during 2021:

1. Cost of purchases (based on vendors' invoices);
2. Trade discounts on purchases;
3. Import duties;
4. Freight *and* insurance on purchases;
5. Other handling costs relating to imports;
6. Salaries of accounting department;
7. Brokerage commission payable to agents for arranging imports;
8. Sales commission payable to sales agents;
9. After-sales warranty costs.

Required: Determine the costs that are considered under IAS # 2 to be included in the calculation of cost of inventory.

Answer: Items 1, 2, 3, 4, 5, *and* 7 are permitted to be included in cost of inventory under IAS # 2.

Salaries of accounting department (item 6), sales commission (item 8) *and* after-sales warranty costs (item 9) are **not** considered cost of inventory under IAS # 2 *and* are **not** allowed to be included in the calculation of inventory cost.

2. Conversion costs

1. Conversion costs are **direct** manufacturing labor **and** manufacturing O.H necessary to convert the raw material into finished product.
2. **Direct** manufacturing labor is **traceable** to units produced *and* easy to calculate.
3. Production O.H should be **allocated** to units produced as follows:

A. Fixed production O.H

- Fixed production O.H *such as* equipment depreciation *and* supervisory salaries will be incurred *regardless* of the production level (within relevant rang).
- Fixed production O.H **must be allocated** to items being produced based on **normal** production capacity *or* **actual** production level *if it approximates or exceeds normal capacity*.
- **Normal** capacity is the expected achievable production level based on the **average** over several periods/seasons, under **normal** circumstances.
- **Normal** capacity takes into account planned maintenance, holydays *and* other normal factors.

Illustrative example: Assume **normal** capacity is 400,000 units and **fixed** O.H amounted to \$1m *then*; per unit **fixed** O.H based on **normal** production capacity is \$2.50.

Assume **actual** production is one of the following levels:

- A. 390,000 units; *or*
- B. 410,000 units; *or*
- C. 300,000 units; *or*
- D. 500,000 units.

Required: Calculate fixed cost per unit produced.

Answer:

Under cases (A) *and* (B) fixed cost per unit produced could be **actual** per unit fixed cost because **actual** production level **approximates normal capacity** *or* could be \$2.50 based on **normal capacity** with the amount of \$25,000 **under allocated** in case (A) **charged** to cost of sales *and* \$25,000 **over allocated** in case (B) **reduces** cost of sales.

Under case (C) low actual production *or* idle plant will **not** result in a higher fixed O.H allocation to each unit. Under **allocated** fixed O.H of \$250,000 (100,000 units × \$2.50) **must** be recognised as **loss** in the period in which they were incurred preferably in a separate line item in P/L *and* each unit produced would be allocated **fixed** O.H \$2.50 based on **normal capacity**.

Under case (D) *when* production is **abnormally high**, the fixed production O.H allocated to each unit will be **reduced** to avoid **inventories** being stated at more than cost *thus*; per unit **fixed** O.H would be \$2 (\$1m/ 0.50m units) allocated between units sold *and* units remained in **inventory**.

B. Variable production O.H

The allocation of variable production O.H to each unit produced is based on the **actual** capacity use because variable O.H varies directly with the volume of production.

Note: Production O.H costs should be allocated based on rational *and* systematic basis *thus*; O.H costs that can't be reasonably allocated to units produced are expensed once incurred as a period expense *rather than* a product cost.

3. Allocated production costs *other than* manufacturing O.H

Common cost (Joint cost) incurred in manufacturing joint products should be allocated to each joint product at split off point using rational *and* consistent allocation method *such as* the 'relative sales value' method.

Illustrative example: Omega manufactures products (X) *and* (Y) using a joint process. The joint processing costs are \$10,000. Assume products (X) *and* (Y) can be sold at split-off for \$12,000 *and* \$8,000 respectively. After split-off, product (X) is processed further at a cost of \$5,000 *and* sold for \$21,000 *whereas* product (Y) is sold *without* further processing.

Required: If Omega uses relative sales value method at split off for allocating joint costs. Calculate joint cost allocated to each product.

Answer:

Joint Product	Selling price at split-off	%	Joint cost allocation	Separable cost	Total cost
(X)	\$12,000	60%	$10,000 \times 60\% = 6,000$	\$5,000	11,000
(Y)	8,000	40%	$10,000 \times 40\% = 4,000$	0	4,000
Total	20,000	100%	10,000		

Thus; the common cost (Joint cost) of \$10,000 is allocated to the joint products (X) *and* (Y) at \$6,000 *and* \$4,000 respectively.

Note: Further processing costs (\$5,000) are separable cost *rather than* joint cost. *Accordingly* it belongs to the product caused its incurrence (product X).

4. Other relevant costs

Costs that are necessary in bringing the **inventories** to their present location *and* condition are part of **inventory** costs. *Such as* special design costs *and* extra processing for specific customer needs.

2/2. Excluded costs

1. The following costs are **not** included in **inventory** costs *rather* it recognised as a period **expenses/losses** *as appropriate* in P/L as incurred:

A. **Abnormal** amounts of wasted materials, labor *or* other production costs;

B. **Storage costs** for finished product *or* merchandise;

C. Distribution costs;

D. Administrative O.H;

E. Foreign currency exchange rate gain *or* loss (G/L) arising **after** inventory acquisition is recognised in P/L in the period exchange rate changed *until* payables are settled;

F. Finance cost; **unless** aging inventory is involved;

2. *When* inventories are purchased on an **extended deferred settlement terms** *such arrangements* contain a financing element that represent the difference between the purchase price for normal credit terms *and* the amount paid. This difference is recognised as **finance cost** over the period of the financing arrangement.

Illustrative example: Sonata purchased **inventory on credit** the price is payable two years later at \$6,050. Assuming interest rate is 10%.

Required: Determine **inventory** cost.

Answer:

$$P.V = \frac{\$6,050}{(1.10)^2} = \$5,000$$

At the date of acquisition

Dr: Inventory \$5,000

Cr: Trade payables \$5,000

At first year-end

Dr: Finance cost [(\$5,000 × 110%) - \$5,000] = \$500

Cr: Trade payables \$500

At second year-end

Dr: Finance cost [(\$5,500 × 110%) - \$5,500] = \$550

Cr: Trade payables \$550

2/3. **Exceptions to actual cost measurement**

For practical purposes two techniques are allowed by IAS # 2 for measuring inventory costs **if** it results in approximate figure to actual cost:

1. **Standard costs**

A. Standard costs can be used to measure inventory costs *especially when* the quantities carried in inventory are low (*such as* in just in time (JIT) situations) **if** the standard is based on normal levels of material, labor, efficiency *and* capacity utilisation.

B. The standard should be updated on a regular basis.

2. **Retail method**

A. Retail method is often used by entities in the retail industry *where* there is a large turnover of inventory items *and* each category has the same gross profit margins.

Illustrative example: The following information is available for Silver for the three months ended 31, March, 2022:

Merchandise inventory 1, Jan 2022 \$900;

Purchases during the quarter \$3,400;

Freight-in \$200;

Sales during the quarter \$4,800

Assume gross margin of this item is 20% of sales.

Required: What should be the merchandise inventory at 31, March, 2022 under **retail method** of inventory valuation?

Answer: *If* the gross profit margin is 20% of sales, cost of sales equals 80% of sales *then*; ending inventory can be determined as follows:

Description	Amount
Beginning inventory	\$900
Add: Cost of purchases	3,400
Add: Freight-in	200
Goods available for sale	4,500
Less: Cost of sales (\$4,800 × 80%)	(3,840)
Ending inventory under retail method	660

Note: The gross profit percentage used should take into account markups *and* markdowns during the period.

B. **Retail method** is used *if* it is the only practical method of inventory valuation.

C. *Even if* **retail method** is used for inventory valuations for interim periods, the ending inventory should be based on actual inventory count *and* valuation.

3/1. Specific identification

Actual unit cost of inventories is required to be determined using **specific identification** method to individual items of inventory *when either*:

A. Items of inventory are **not** interchangeable; *or*

B. Goods are produced *and* segregated for specific projects (Job order for example).

Thus; *when* specific inventory is clearly identified from the time of purchase through the time of sale, the firm's operations may be viewed as a series of separate transactions.

3/2. Cost formulas

1. Much of business activity involves goods whose identity is lost between the time of acquisition *and* the time of sale because the items of **inventory** are **interchangeable** (identical/fungible). In this case the **actual cost of inventories** should be measured using *either* **first in first out** (FIFO) *or* **weighted-average** (W.A) cost formulas.

2. Last in first out (LIFO) formula is **not** permitted under IAS # 2.

3. **FIFO** and **W.A** cost formulas can be calculated based on **perpetual** or **periodic** inventory systems.

Illustrative example (1): Vigo uses the **weighted-average** cost method to value inventory.

The following are the purchases *and* sales made by Vigo during 2021:

Purchase date	Description	Selling date	Quantity sold
Jan, 2021	100 units @ \$250 per unit	March 2021	150 units
Feb, 2021	150 units @ \$300 per unit	Dec, 2021	170 units
Sep, 2021	200 units @ \$355 per unit		

Required: Calculate **inventory** costs *and* cost of sales under **weighted average** method assuming

A. Vigo records **inventory** under **perpetual inventory** systems;

B. Vigo records **inventory** under **periodic inventory** systems.

Answer:

A. Cost of **inventory** under **weighted moving average** (perpetual)

Date	Purchases			Sales			Inventory balances		
	Q	Price	Amount	Q	Price	Amount	Q	Price	Amount
Jan, 2021	100	\$250	\$25,000				100	\$250	\$25,000
Feb, 2021	150	300	45,000				250	280*	70,000
March, 2021				150	280	42,000	100	280	28,000
Sep, 2021	200	355	71,000				300	330	99,000
Dec, 2021				170	330	56,100	130	330	42,900
Cost of goods available for sale (450 units)			\$141,000	Cost of sales (320 units)			Inventory (130 units)		\$42,900

Illustrative example (2): XYZ commenced its operation in 1, Jan, 2021 it uses the **FIFO** method to value its inventory. The following are the purchases *and* sales made by the entity during the year 2021:

Purchase date	Description	Selling date	Quantity sold
Jan, 2021	10,000 units @ \$25 each	May, 2021	15,000 units
March, 2021	15,000 units @ \$30 each	Nov, 2021	20,000 units
Sep, 2021	20,000 units @ \$35 each		

Required: Calculate **inventory** costs *and* cost of sales under **FIFO** method assuming:

A. XYZ records **inventory** under **perpetual inventory** systems;

B. XYZ records **inventory** under **periodic inventory** systems.

Answer:

A. Cost of inventory under FIFO perpetual

Date	Purchases			Sales			Inventory balances		
	Q	Price	Amount	Q	Price	Amount	Q	Price	Amount
Jan, 2021	10,000	\$25	\$250,000				10,000	\$25	\$250,000
March, 2021	15,000	30	450,000				10,000	25	250,000
							15,000	30	450,000
May, 2021				10,000	25	250,000	10,000	30	300,000
				5,000	30	150,000			
Sep, 2021	20,000	35	700,000				10,000	30	300,000
							20,000	35	700,000
Nov, 2021				10,000	30	300,000	10,000	35	350,000
				10,000	35	350,000			
Cost of goods available for sale (45,000 units)			\$1,400,000	Cost of sales (35,000 units)		\$1,050,000	Inventory (10,000 units)		\$350,000

Note: **FIFO** concerns cost follow *rather than* physical flow of units (the price of first purchase is debited first to cost of sales meaning that **inventory** units will be valued at last prices (\$35).

B. Cost of inventory under FIFO periodic

Cost assigned to ending **inventory** based on **FIFO periodic** is the last purchase price at \$35 per unit.

Thus: Ending **inventory** under **FIFO periodic** = 10,000 units × \$35 = \$350,000

Rule: The cost would be the same under **FIFO perpetual** *and* **FIFO periodic**.

4. According to IAS # 2; an entity should use the same cost formula for all **inventories** having similar **nature** *or* similar **use** to the entity. For **inventories** with different **nature** *or* different **use**; different cost formulas may be justified.

5. A difference in geographical location of **inventories** by itself is **not** sufficient to justify the use of different cost formulas.

4/1. Lower of Cost and NRV

At each reporting period, inventories are measured at the 'lower of cost and net realisable value (NRV)'

1. **NRV** is the estimated selling price in the ordinary course of business less estimated cost to complete, repair or modify and sell.

Illustrative example: Hero values its inventory at the lower of cost or NRV as required by IFRS Accounting Standards. Hero has the following information regarding its inventory:

Historical cost \$1,000;

Estimated selling price \$900;

Estimated costs to complete and sell \$50;

Replacement cost \$800.

Required: What is the amount for inventory that Hero should report on the SFP under the lower of cost or NRV?

Answer:

NRV = Estimated selling price \$900 - estimated costs to complete and sell \$50 = **\$850**

The lower of cost or NRV is determined by comparing the cost of \$1,000 to the NRV of \$850 and using the lower amount. Inventory should be reported at **\$850**.

2. Situations in which NRV is likely to be less than cost:

- A. A fall in selling price;
- B. An increase in the purchase or manufacturing costs that is not accompanied by an equivalent increase in sales price;
- C. An error in the calculation of purchase or manufacturing costs;
- D. A physical deterioration in the condition of inventory due to damage, obsolescence or other factors; or
- E. A decision as part of the entity's marketing strategy to sell products at less than cost.

Illustrative example: ABC manufactures and sells paper envelopes. The stock of envelopes was included in the closing inventory as of 31, Dec, 2021 at a cost of \$50 each per pack. Sale price for the inventory at 15, Jan, 2022 was \$40 each per pack. Furthermore inquiry reveals that; during the physical stock take a water leakage has created damages to the paper and the glue. Accordingly in the following week ABC spends a total of \$16 per pack for repairing and reapplying glue to the envelopes.

Required: Determine the **NRV** and inventory write-down.

Answer:

NRV = Sale price \$40 less any cost incurred to bringing the good to its salable condition \$16 = \$24 per pack.

The **inventory write-down** per pack is the difference between cost \$50 and **NRV** \$24 = \$26 per pack.

3. **NRV** should be assessed based on the **most reliable information** available at year-end.

4. Fluctuations of sales price or cost after the reporting period are **adjusting events** if they confirm conditions existing at the year-end.

5. **Inventories** are usually written down to their **NRV** as an expense/loss in P/L on an **item-by-item basis**. Similar or related items may be grouped together in the **same product line** but grouping is **not acceptable** based on a whole classification (e.g. materials or finished goods) or all **inventories** in a geographical segment or the whole business.

Illustrative example: A company has inventory at year-end as follows:

Item	Units	Prime cost	Production O.H	Selling cost	Expected selling price
A	300	\$160	\$15	\$12	\$185
B	250	50	10	10	75

Required: Calculate the amount of **inventories** in the SFP in accordance with IAS # 2 assuming that item (A) is **unrelated** to item (B).

Answer: Prime cost = Direct material + Direct labor.

Item	Units	Production cost	NRV	Lower	Total inventory
Item (A)	300	$\$160 + \$15 = \$175$	$\$185 - \$12 = \$173$	\$173	\$51,900
Item (B)	250	$50 + 10 = 60$	$75 - 10 = 65$	60	15,000
Total					66,900

Notes:

1. Item (A) is valued based on **NRV** while item (B) is valued based on cost.

2. Because items of **inventory** are **not related**, it is **unacceptable** to value **inventory** at \$67,500 based on the following aggregation:

Item	Units	Inventory based on cost	Inventory based on NRV
Item (A)	300	$300 \times \$175 = \$52,500$	$300 \times \$173 = \$51,900$
Item (B)	250	$250 \times 60 = 15,000$	$250 \times 65 = 16,250$
Total		67,500	68,150

6. The **reasons** why **inventory** is held should be considered *when* valuing **inventory**; some **inventory** items may be held to satisfy a sales **contract** *then*; its **NRV** will be **based on the contract price**. Any additional **inventory** of the same type held at the year-end will be assessed according to **market sales prices** available *when* **NRV** is estimated.

7. **Inventories** of raw materials *and* other supplies held for use in production are **not** written down below cost *if* the finished products in which they will be used are expected to be sold at *or* above cost. *However when* the cost of the finished product exceeds **NRV** *and* at the same time the replacement cost of raw material are decreased, the materials are written down *in such case* to its **replacement cost** because the replacement cost of the raw materials may be the **best measure of NRV**.

Remember: **inventory** is not valued at the lower of cost *or* replacement cost *but* are valued based on the lower of cost *or* **NRV**.

Illustrative example: Fontana has the following items of **inventory**.

A. Materials costing \$10,000 bought for processing *and* assembly for a **profitable special order**. Since buying these items, the cost price has fallen to \$7,000.

B. Equipment constructed for a customer for an agreed price of \$18,000. This has recently been completed at a cost of \$16,800. It has now been discovered that; in order to meet certain regulations, conversion with an extra cost of \$5,000 will be required. The customer has accepted partial responsibility *and* agreed to meet half the extra cost.

Required: In accordance with IAS # 2 '**Inventories**', at what amount should the above items be valued?

Answer:

A. **Inventory** is valued at the lower of cost *or* **NRV** **not** the lower of cost *or* replacement cost. Since the materials will be processed for a **profitable sale**, there is no reason to believe that **NRV** will be below cost. *Therefore* the **inventory** should be valued at its cost of \$10,000.

B. **NRV** = Contract price \$18,000 - entity's share of modification cost \$2,500 = \$15,500. The **NRV** is below the cost. *Therefore* the **inventory** should be held at \$15,500 *resulting in* a write down of **inventory** = \$16,800 - \$15,500 = **\$1,300**.

8. **NRV** must be reassessed at the end of each period the **inventory** still on hand *and* compared again with cost. *If* the **NRV** has risen (*due to* improvement in sales price) *then*; the previous write down must be **reversed** in P/L. **Reversal is limited to the original write-down**.

5/1. Cost of sales

When inventory is sold, the carrying amount of inventory should be recognised as an expense (cost of sales) *when* the related revenue is recognised.

6/1. Required disclosures under IAS # 2

1. Accounting policies adopted for **measuring inventories** (i.e. actual cost, standard cost *or* retail method) **and** the **cost flow assumption** (i.e., cost formula) used;
2. Total carrying amount *as well as* amounts classified *as appropriate* to the entity; common classifications are:
 - A. Merchandise;
 - B. Production supplies;
 - C. Materials;
 - D. Work in progress;
 - E. Finished goods.
3. Carrying amount of any **inventories** carried at **NRV**;
4. Amount of any write-down of **inventories** recognised as an expense (loss) in the period'
5. Amount of any reversal of a previous write-down *and* the circumstances that led to such reversal;
6. Carrying amount of **inventories** pledged as security for liabilities.